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To: Maryland General Assembly

From: Bob Brennan

Date: February 22, 2006

RE: MEDCO's response to Legislative Analyst

1.) DLS recommends that MEDCO terminate the contract with KPMG for non performance after the financial statements for fiscal 2005 are completed and retain a new accounting firm for fiscal 2006 financial statements.

Response: MEDCO agrees with the analyst recommendation and MEDCO has already obtained consent from its Board of Directors in January to interview and retain a new accounting firm.

MEDCO takes the reporting requirements seriously and has instituted additional steps to enhance its accounting functions. The additional actions include:

A) Hiring an Assistant Controller in February 2005
B) Currently in the process of hiring an accounting assistant
C) Engaged a consulting firm to assist in automating the transfer of information from our management companies to MEDCO

MEDCO is in the process of interviewing accounting firms with the target of engaging a new firm by April 1, 2006. MEDCO will also monitor the audit schedule to assure a timelier reporting of the financial information.

2.) DLS recommends that MEDCO brief the committees on the losses associated with the Rocky Gap project and the financial outlook for fiscal 2006 and 2007. MEDCO should also comment on the potential impact these losses may have on MEDCO and State's investment and on options for the State if Rocky Gap is unable to become profitable.

Response: Rocky Gap's financial performance has been improving but continues to be insufficient to service its debt obligations. In FY 2005, Rocky Gap achieved its best level of operating performance and the improving trend is expected to continue. Since the capital improvements were completed in September of 2004, MEDCO has viewed the operations as a restart and as with any new operation it will take three years to get to stabilization. MEDCO has targeted 2007 as the year in which stabilization should occur.

The projected financial outcomes after 2007 will fall short of being able to service the debt at its current level and will require MEDCO to restructure the $26,200,000 of investor debt. MEDCO has discussed the concept of restructuring with the investors and they have deferred addressing the issue until the end of the first quarter of 2006. MEDCO has engaged a financial advisor to assist in the discussions and the negotiations with the investors.

To date, the investors have been extremely patient and have not put the debt in default but have worked with MEDCO through a forbearance arrangement. The investors have continued in extending the interest holiday through June of 2005 and MEDCO will be formally requesting another extension. The investors consented to the line of credit to support the seasonal working capital requirements for 2005 and MEDCO is in the process of requesting a line of credit for 2006. The seasonal line of credit is drawn upon in late winter or early spring and is cleaned up in late summer or early fall. In the fall of 2005, MEDCO also requested the investors to consent to the expenditure of $909,000 for room renovations and a new integrated property management system that will consist of both hardware and software. All of those expenditures will be paid for by cash generated from the operations in 2005 and the funds are in the bank.

The operations and management of Rocky Gap is conducted under contract by Crestline Hotels and Resorts. The financial forecast is prepared on calendar basis. The following is a comparison of the 2006 projection to the 2005 performance:

	2006	2005
Gross Revenue	$12,010,287	$9,985,547
Total Department Profit	$5,267,416	$4,395,635
G and A Expenses	$3,523,194	$3,704,038
House Profit	$1,744,222	$691,596
Net Income	$380,797	$258,630

Note: The planned capital improvements are expensed through the P&L. Between 2005 and 2006 the capital expenditures are projected to total $1,415,582

Capital improvements had been deferred in prior years due to a lack of funds. On a normalized basis the repair and maintance and capital improvements should be approximately $500,000 per year.

A five year plan was prepared in early 2005 and the projection for 2007 at that time is as follows:

	2007
Gross Revenue	$12,788,432
Total Department Profit	$6,254,694
G&A Expenses	$3,607,570
House Profit	$2,647,124
Net Income	$1,687,869

Note: The above net income is before interest and other expenses.

In regards to Legislative Services concerns over the potential impact losses may have on MEDCO and the State's investment and the options for the State if Rocky Gap is unable to become profitable, MEDCO has the following response:

Rocky Gap was financed with a combination of public and private debt. The private debt is secured by the revenues of the project and the investors **do not** have a fee simple mortgage on the real property or improvements. The public debt is subordinated to the private debt and therefore no payments on the public debt can be made unless the private debt is being serviced in accordance with the terms. The likely hood of the public debt being serviced in the near future is highly remote. The value of the investment to the private investors is based on the ability of the operations to generate cash.

The transaction is structured such that the private debt is not back by the full faith of credit of the State of Maryland, Allegany County or MEDCO and there is no moral obligation or guaranty to the private investors.

MEDCO expects the investors will continue to work with the project so they can ultimately salvage some return on their investment. If they were to sell their investment today it would most likely be at a deep discount. If the investors wait until the operations stabilize they should be able to obtain a higher return albeit at a discount from the outstanding principal and accrued interest.

The project was financed with tax exempt bonds and is exempt from real and personal property taxes. If the investors foreclose, there would negative consequences to the value of the investment if MEDCO's involvement is terminated. Specifically, the interest recognized by the private investors would become taxable and the property would revert back to taxable status.

Until MEDCO engages the investor in discussion and negotiations over a restructuring will the future prospects be known. I any event it is highly unlikely that the facility will be closed. The prospect for a closure would most likely occur if the revenues were not sufficient to support the annual operating and up keep expenses. At this time the revenues are adequate to support the operating cost.

MEDCO views Rocky Gap as being successful from an economic development perspective. Allegany County is a One Maryland County and has not shared in the economic prosperity as the majority of the State. Rocky Gap was established to jump start tourism in Western Maryland and bring greater attention to Mountain Maryland. One of the impediments in marketing Rocky Gap was, there was no established customer base. Rocky Gap has had to create a market where one did not previously exist. Since Rocky Gap opened the region has been experiencing an increase in tourism which has occurred in conjunction with the redevelopment of Baltimore Street in downtown Cumberland which is adjacent to the Western Maryland Scenic Railroad station and Canal place. The Resort , located in the State Park, also markets heavily to the outdoor experience which is complemented by having Western Maryland Adventures located in the Rocky Gap lobby to arrange activities which include horse back riding, bass fishing, fly fishing, rafting trips, canoeing, kayaking, mountain biking and other adventure sports related activities.

3.) **Chesapeake Bay Conference Center: DLS recommends that MEDCO brief the committees on when the operating income will become sufficient to cover principal and interest payments on this debt and how capital facility renewal expenses and replacement of furniture and equipment will be replaced if reserves are used to cover debt service.**

Response: The following is an analysis demonstrating the operations generate sufficient cash to fund its current debt and operating expenses for FY 2005.

Maryland Economic Development Corporation
Chesapeake Bay Conference Center
Year Ending June 30, 2005
(000's)

Revenue	41,942
Expenses	49,837
Net Asset Inc (Dec)	(7,895)

Add Back:	
Depreciaton	6,817
Amortized Expenses	0
Bond Interest Expense	10,465
Subordinated Interest Expense	2,513
Deferred Expenses:	
Mgmt Fee	1,535
Medco Service Fee	373
Asset Mgt Fee	487
Ground Rent	1,233
Less unrealized gain on DSR	(1,510)
Net Available for Debt Service	14,018
FY 05 Debt Service	
Bond Principal	0
Bond Interest	10,465
Capitalized Interest	0
Total Debt Service	10,465
Current Reserves	
Debt Svc Reserve	12,586
FF&E Replacement	1,072
Total Reserves	13,658

The FY 2006 operating results are projected to show a continued improvement over 2005 with an 8.3% projected increase in revenue to $43,359,000. After expenses the operations will generate at least $1,000,000 more in cash than what was generated in 2005 or approximately $15,000,000 before debt service. Included in the operating cost are reserves for furniture, fixture and equipment (FF&E) replacement, in 2005 $1,107,000 was reserved and the reserve for 2006 is estimated to be $1,300,000. The amount of funds to be reserved for FF&E in 2006 is equal to 3% of revenues. The FF&E reserves are adequate to keep the resort fresh and current.

4.) **Student Housing Projects: It is recommended that MEDCO brief the committees on what steps it is taking to address the above problem. It is also recommended that MEDCO provide a detailed spreadsheet on each student housing project that fully and**

separately discloses revenue including accounts receivables and all obligations including debt service, management fees, ground rent and reserves.

Maryland Economic Development Corporation
Student Housing Projects in 000's
Year Ending June 30, 2005

	Bowie	Frostburg	Morgan State	Salisbury	UMAB	UMBC	UMCP Housing	University Village	Total
Revenue	2,651	1,972	4,616	1,660	2,467	3,914	5,465	4,514	27,259
Expenses	2,719	2,742	5,564	1,743	3,949	4,806	6,005	5,879	33,407
Net Asset Inc (Dec)	(68)	(770)	(948)	(83)	(1,482)	(892)	(540)	(1,365)	(6,148)
Add Back:									
Depreciation	800	569	1,392	554	1,218	1,632	1,396	1,061	8,622
Amortized Expenses	17	27	56	20	38	26	1	68	
Interest Expense	935	1,059	2,289	645	1,593	1,375	2,591	2,091	12,578
Deferred Expenses:									
Mgmt Fee	0	40	239	79	57	143	151	217	926
Ground Rent	0	0	0	0	0	0	0	1,059	1,059
Net Available for Debt Service	1,684	925	3,028	1,215	1,424	2,284	3,599	3,131	17,037
FY 05 Debt Service									
Bond Principal	395	240	0	265	0	640	895	360	2,795
Bond and Other Interest	1,122	1,059	2,289	774	1,907	1,511	2,928	2,091	13,681
Capitalized Interest or SBI	(187)	(54)	(10)	(129)	(352)	(136)	(337)	0	(1,103)
Total Debt Service	1,330	1,245	2,279	910	1,555	2,015	3,486	2,451	15,271
Current Reserves									
Debt Svc Reserve	1,554	1,286	2,742	1,135	2,554	2,507	3,828	1,976	17,582
Repair & Replacement	73	140	49	51	77	157	263	65	875
Operations								273	273
Mgmt Fee							39		39
Surplus			208		161	880	29	156	1,434
Total Reserves	1,627	1,426	2,999	1,186	2,792	3,544	4,159	2,470	20,203

The analyst sites four student housing projects with operating difficulties. The First, Frostburg State University experienced operational problem in its first year of operations. The management company did not coordinate with the University to assure the facility would be fully leased. The owner of the original management company had passed away and the management company was unable to maintain their stellar reputation. MEDCO worked with the University System and Frostburg University to coordinate and retain a new management company. The new management company has worked through the operational issues and MEDCO projects the operations will be financially viable and stabilized before the end of the calendar year.

The situation with Bowie State University deals with the collection of rents, while the accounts receivables were approximately $175,000 at the year end over $217,000 in accounts had been written off as uncollectible. The manager at BSU did not coordinate with the University to assure the manager was aware of the students' receipt of financial aid and the student had the capacity to pay their rent. MEDCO and the University have not been pleased with the manager's performance and had been in discussions on how to replace the manager. In January the current management company gave notice of their desire not to continue as manager. MEDCO has coordinated the interviewing of a replacement manger with University officials and a decision has been made on a new manager. The new manager should be in place by April 1, 2006.

MEDCO feels the coordination of the operations particularly the receipt of rents will remedy any and all of the financial deficiencies on this project.

The Morgan and University of Maryland Baltimore had the same management company and MEDCO is currently working to transition in new managers. . The new manager for UMB should be fully mobilized by March 1 and the new manager for Morgan should be in place by April 1.

MEDCO is optimistic the Morgan and UMB projects will ultimately stabilize but the impact of the new mangers will not be fully realized until 2007

Point 1: In the past, MEDCO received student housing projects with the development and management teams already identified. MEDCO has been building its relationship with the University of Maryland System and will work more closely with the System in the future to assure the development and management teams picked for these projects have the requisite experience to perform in a highly effective capacity

Point 2: The occupancy rates at UMB and MSU have not been adequate to generate the revenues to fully service the obligations of the operations. The deficiencies have been the result of poor coordination by the manger with the University to assure these facilities are integrated into the schools offering of available housing. Moreover, the manager had failed to coordinate the commitment of students to re-lease for their next school year and was hoping the students would just show up at the beginning of the semester.

Point 3: At the University's where there is a high rate of students receiving financial aid, there needs to better coordination with the financial aid office to notify the manager when students have received their funding. The system can not hold back student grades for non payment but they can better educate the students on their responsibility to pay for their rooming upon receipt of the financial aid.

Point 4: The schools can not hold the students accountable by holding back grades or transcripts as it would jeopardize the indirect nature of the obligation to the University. The best method is to educate students on their financial responsibility and coordinate the notification of financial disbursement with the manager.

Point 5: The University can not mandate that a student live on campus. There are many advantages for a student to live on campus and the University's attempt to highlight those advantages. The University can relax certain standard as to which student can access housing compared to dorms. Dorms are traditionally for freshman and sophomores and housing is for the juniors or seniors.

Point 6: The signing of contracts before the fall terms during the spring term is a standard operating procedure for any student housing management company. MEDCO believes the manager that have not performed well in this capacity have been identified and are in the process of being replaced.